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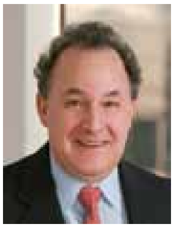

The Strict Compliance Requirement for Letters of Credit is Really Strict

Letters of credit can be a very powerful risk mitigation tool for goods sellers and service providers. A letter of credit issuing bank must pay the beneficiary (e.g., a goods seller or service provider) presenting documents required by the letter of credit. Anything less raises the risk that the beneficiary will not be paid on the letter of credit.

The U.S. Court of Appeals for the Second Circuit (the "Second Circuit") in *Mago International LLC v. LHB AG f/k/a LHB Internationale Handelsbank AG* recently applied the strict compliance standard, which is followed by a majority of the courts, in determining whether the beneficiary had presented the necessary documents to obtain payment on a standby letter of credit. The letter of credit beneficiary had unsuccessfully attempted, on multiple occasions, to draw on a letter of credit. The bank had refused to honor the draws because the beneficiary did not timely present copies of signed bills of lading evidencing shipment of the underlying food products as required by the letter of credit.

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The *Mago International* decision illustrates the importance of providing simple documentary requirements in a standby letter of credit to ensure that the letter of credit beneficiary can present the required documents for payment. Otherwise, the beneficiary is at risk of not being paid, despite being proactive in the first instance in seeking a letter of credit.

Overview of Letters of Credit

Letters of credit play an integral role in many business transactions, especially international transactions. They involve three independent contracts.

The first contract oftentimes arises out of the sale of goods or provision of services. The seller requires the buyer to obtain a letter of credit in favor of the seller, as

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a condition to selling goods or providing services, in order to reduce the risk of nonpayment.

The second contract is between the bank and the applicant (in this context, the purchaser of goods or services), where the bank agrees to issue a letter of credit. This contract includes the terms governing the letter of credit, the applicant's obligation to reimburse the bank for the bank's payments made to the beneficiary upon the presentation of conforming documents, the collateral that secures payment of the applicant's reimbursement obligation to the bank, and all fees the applicant owes to the bank for issuing, or otherwise, in connection with the letter of credit.

The last contract is the letter of credit that a bank issues in favor of the beneficiary (in this context, the goods seller or service provider). Upon the beneficiary's presentation of all of the documents required by the letter of credit, the bank is obligated, under virtually all circumstances, to pay the amount sought by the beneficiary.

The majority of courts require that the documents a beneficiary presents to the issuing bank strictly comply with the requirements of the letter of credit.[1] This allows the bank, dealing only in documents, to act quickly and ensure that the letter of credit will be honored without unnecessary delay.

The three contracts are also independent of one another. By way of example, the bank must pay on a letter of credit if the beneficiary presents the documents required by the letter of credit, irrespective of the existence of disputes between the beneficiary and applicant under the underlying goods or services contract. Likewise, the applicant's financial wherewithal to reimburse the bank for the draws made on the letter of credit or the amounts otherwise due from the applicant to the bank has no bearing on the other two contracts.

Standby Versus Documentary Letters of Credit and Confirmed Letters of Credit

There are two types of letters of credit. The first is a documentary letter of credit, where the seller/letter of credit beneficiary looks solely to the bank for payment. This type of letter of credit is frequently used in international trade. The documents that a beneficiary must present usually include invoices, shipping documents, packing lists, insurance-related documents and other documents evidencing the beneficiary's sale and delivery of goods or provision of services to the purchaser/letter of credit applicant.

Unlike a documentary letter of credit, the beneficiary of a standby letter of credit must first look to its customer for payment. A standby letter of credit serves as a backstop for the customer's obligation to pay the beneficiary. The beneficiary can draw on a standby letter of credit if the purchaser/applicant fails to timely pay its obligations to the beneficiary. As such, a standby letter of credit should contain simpler documentary requirements than those contained in a documentary letter of credit. These requirements can be as simple as the beneficiary presenting a statement to the issuing bank that the customer/applicant has outstanding indebtedness to the seller/beneficiary. As the *Mago International* decision illustrates, a seller/beneficiary risks nonpayment of a standby letter of credit that contains more detailed documentary requirements.

> The majority of courts require that the documents a beneficiary presents to the issuing bank need to strictly comply with the requirements of the letter of credit.

A seller might also be concerned about the issuing bank's ability to pay in response to a compliant draw, particularly when the bank is located in a different country and/or has financial difficulties. In these circumstances, the seller can request the issuance of a confirmation by a separate bank, known as the confirming bank, that is more creditworthy and/or is located in the seller's country. A confirming bank agrees to pay the beneficiary upon the beneficiary's presentation of all of the documents required by the letter of credit.

Facts

Mago International ("Mago") agreed to sell food products to N.T.P. Genita ("Genita"), a company based in Kosovo. As a condition to the sale, Genita was required to procure an irrevocable letter of credit and a confirmation of the letter of credit in favor of Mago. Genita obtained a standby letter of credit (the "L/C") from the Bank for Business ("BFB") located in Kosovo. The L/C was confirmed on Oct. 7, 2011 by a German bank, LHB AG ("LHB"). The expiration date of the L/C was Oct. 8, 2012.

The L/C required Mago to present, among other documents, a photocopy of bill(s) of lading evidencing shipment of the food product to Genita. Mago was also required to submit the documents "IN COMPLIANCE WITH THE TERMS AND CONDITIONS OF THE CREDIT [and] THE UNIFORM CUSTOMS AND PRACTICE OF L/C [letters of credit]" as determined by the "UCP LATEST VERSION [UCP 600]." (the "UCP"). Significantly, UCP Article 20 defines a "bill of lading" as a signed original document.

> A standby letter of credit should contain simpler documentary requirements than those contained in a documentary letter of credit.

Consistent with the parties' contract, Mago delivered the food products to two shipping companies, Mediterranean Shipping Company ("MSC") and CMA GGM (America) LLC ("CMA"). MSC shipped food product included on invoice numbers 199(1-5) and 199(6-7), while CMA shipped food product under invoice numbers 208(1-2) and 208(3-5). Genita failed to pay for any of the food product. Mago then sought payment of $260,000 from LHB under the L/C due to Genita's failure to pay.

Mago made several attempts to present conforming documents to LHB. Initially, on Sept. 19, 2012, Mago tendered its first set of documents to LHB, which included two unsigned bills of lading[2] relating to the two invoices beginning with number 199. LHB rejected this tender on Sept. 24, 2012 because, for among other reasons, the bills of lading were (a) unsigned, and (b) copies of non-negotiable bills of lading, rather than the original bills of lading.[3] Next, on Sept. 28, 2012, Mago tendered a second set of documents that did not remedy the deficiencies from the first tender related to the bills of lading associated with the 199 series invoices. LHB again rejected this tender because, like the first tender, it included the same unsigned bills of lading that did not conform to the L/C's requirement for copies of bills of lading evidencing the shipment of food to Genita.

Mago then submitted a third set of documents on Oct. 8, 2012, the date the L/C expired, that included telexes from MSC, instead of the unsigned bills of lading. These telexes stated that MSC had copies of the original bills of lading in its files and that the carrier authorized the release of the shipments to Genita without receiving copies of the original bills of lading. LHB also rejected this submission as noncompliant with the L/C's requirements.

Finally, on Oct. 11, 2012—after the L/C's expiration—Mago tendered copies of signed bills of lading relating to the 199 series invoices. LHB rejected this submission as late based on the expiration of the L/C prior to Mago's submission of these documents.

Procedural History

Mago subsequently filed a lawsuit against LHB and BFB[4] in the U.S. District Court for the Southern District of New York (the "Southern District"), alleging wrongful dishonor of the L/C. Both LHB and Mago cross-moved for summary judgment. The Southern District granted LHB's summary judgment motion, dismissing Mago's complaint and denying Mago's summary judgment motion.

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The Second Circuit's Decision

The Second Circuit affirmed the Southern District's decision and upheld LHB's dishonor of Mago's draw on the L/C. LHB was not required to honor any of Mago's attempts to draw on the L/C prior to the expiration of the L/C as the documents did not strictly comply with the L/C's documentary requirements. Mago's presentation of unsigned copies of bills of lading, which by their own terms required a signature to evidence shipment, did not evidence the shipment of goods to Genita.

The Second Circuit rejected Mago's primary argument that, whereas a letter of credit requires "copies" of documents evidencing the shipment of goods (e.g., bills of lading), such documents do not need to be signed pursuant to the UCP and related interpretive guidance. The Second Circuit noted that the L/C required copies of bill(s) of lading that "evidenc[ed] shipment of the goods to the applicant." Mago's presentation of unsigned bills of lading did not strictly comply with the L/C's documentary requirements, particularly where the bills of lading explicitly required a signature to evidence shipment. The Second Circuit also rejected Mago's argument that the telexes Mago had presented to LHB satisfied the L/C's documentary requirements because the L/C specifically required that the shipping confirmation be included in the bills of lading, not in telexes.

Conclusion

The *Mago International* case illustrates the risk of a letter of credit beneficiary's failure to strictly comply with the letter of credit's documentary requirements. Mago's inability to obtain copies of signed bills of lading until after expiration of the L/C was fatal to Mago's ability to obtain payment on the L/C. Mago could have easily avoided this risk by insisting that the L/C require only Mago's submission of a simple statement of nonpayment by Genita, or at least state that the bills of lading must be signed. Mago's failure to take these easy steps eviscerated the entire purpose of obtaining the letter of credit: to protect against payment risk.

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1. The easier-to-satisfy substantial compliance standard, followed by a minority of courts, is not the governing law in the Second Circuit (which includes New York), where the *Mago International* case was pending.
2. The bills of lading relating to these two invoices included language requiring MSC's signature on the bills of lading as evidence that the food product was actually shipped.
3. It appears that LHB did not have an issue with the photocopies of the bills of lading submitted by Mago in support of the invoices beginning with number 208 because they were signed by CMA. However, the Second Circuit's decision did not distinguish between the 199 and 208 series invoices because Mago did not properly preserve that issue on appeal.
4. The District Court dismissed the complaint against BFB because BFB was never properly served with Mago's complaint.

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